Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	
	)	

Comments of the United States Telephone Association
on Petitions for Reconsideration

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SUMMARY

Three parties, MCI, AT&T and the Ad Hoc Telecommunications Users Committee request that the Commission reconsider its decision in the First Report and Order in this proceeding. These parties have raised no arguments which warrant reconsideration of the various aspects of the order discussed in their petitions. Petitioners essentially ask the Commission to alter or reverse its fundamental policy decisions to promote efficiency incentives for LECs through pure price cap regulation; to create incentives to further productivity; and to design price cap regulations appropriate to an environment of increased competition for LEC services. Their proposals would in fact disserve the public interest and should therefore be rejected. The Commission should instead take further steps to implement its fundamental policy goals, including development of a TFP-based productivity offset, elimination of sharing, and increased pricing flexibility.

In particular, the petitioners demonstrate absolutely no basis for raising the interim productivity factor. The FCC should also retain its policy of giving LECs price cap options from which to choose, and petitioners are wrong in suggesting the low-end adjustment factor mechanism for LECs electing the lower productivity factors should be removed. Finally, the Commission should again reject MCI's suggestion to require an additional exogenous change in conjunction with sales and swaps of exchanges.

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The United States Telephone Association (USTA) submits these comments in response to the Petitions for Reconsideration in the above-captioned docket. USTA is the principal trade association of the local exchange carrier (LEC) industry.

Three parties, MCI, AT&T and the Ad Hoc Telecommunications Users Committee (Ad Hoc) request that the Commission reconsider its decisions in the First Report and Order in the above-captioned docket.[1] For the reasons stated below, USTA submits that petitioners have not demonstrated that their suggested changes to the interim price cap plan are warranted. Rather, petitioners' proposals would disserve the public interest and are contrary to established Commission policy decisions. The petitions should be denied.

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[1] Price Cap Performance Review for Local Exchange Carriers, First Report and Order, CC Docket 94-1, FCC 95-32 (released April 7, 1995)("First Report and Order").

I. The Petitioners Do Not Demonstrate a Basis For Raising the Interim Productivity Factor.

A. The Interim Productivity Factors Selected Are Not Erroneously Low.

1. The Fact That Many Carriers Chose an Interim Factor of 5.3% Provides No Support for Concluding that the Interim Factor Should Be Higher.

Petitioners contest the Commission's decision with respect to an interim productivity offset, despite the fact that the Commission raised the minimum productivity figure by over 20%. Petitioners' arguments merely repeat their previously stated positions and are based more on hunches than facts or logic. For example, MCI argues that "[m]ost LECs chose the Commission's highest option [of 5.3 %] . . .[t]his indicates that the LECs could easily achieve a productivity factor of 5.7%." MCI Petition at 5; see also AT&T Petition at 4-5 ("the fact that all but four price cap LECs selected the higher optional factor demonstrates that it is 'comfortably' within the capabilities of those carriers").[2]

The absence of logic in this argument is telling. There is no basis to suspect that achieving productivity levels of 5.3% will be easy; petitioners are simply wrong that the selection of 5.3% evidences an ability to obtain higher productivity levels "easily." Petitioners present absolutely no deductive reasoning to suggest that the minimum productivity offset of 4.0 is erroneously low; in fact precisely the opposite is more likely true: it is very possible that 4.0% productivity is beyond the uppermost boundary of what LECs can achieve.

[2] LEC tariff entities representing 33% of the total interstate revenue under price caps chose the 4.0% productivity offset / sharing 50/50 between 12.25% and 13.25% option.; these were NYNEX, SNET, US West, and tariff entities representing approximately 54% of GTE. All other price cap tariff entities, representing 67% of price cap revenue, chose the 5.3% productivity offset / no sharing option. No price cap tariff entities elected the 4.7% productivity offset / sharing 50/50 between 12.25% and 16.25% option.

The LECs selecting the 5.3% productivity offset did so because the absence of an associated sharing obligation is a more positive incentive than the alternatives which retain this vestige of rate-of-return regulation. The basic choice for the LECs was between a form of rate-of-return (ROR) regulation with an earnings cap of 12.75% and a form of pure price cap regulation with a higher productivity offset provision. The hybrid price cap/rate of return associated with lower productivity offsets, which requires carriers to "add-back" the effects of sharing, is a particularly restrictive form of regulation. Perhaps all that can be said is that the price cap LECs predominately chose the form of pure price cap regulation over ROR regulation.

There are also additional reasons why LECs elected the 5.3% interim productivity option. The FCC's options layer different sharing parameters on top of productivity offset options. Carriers needed to take into account the financial effects of operating under both the productivity offset and the associated sharing provisions. Indeed, referring to GTE's Comments in Support of Joint Petition for Partial Stay filed in this docket June 7, 1995, GTE says (at 3) that it selected for the coming eleven months a combination of options that produces the least unfavorable result for GTE. This selection, GTE says (id.), "was driven by the fact that, in [certain] areas, the 1.3 incremental difference between 5.3 and 4.0 had less near-term harmful impact on GTE's earnings than the exogenous or Z factor impact of sharing." In selecting 5.3%, GTE stresses (id.) that it is simply responding to the incentives dictated by the Commission's orders attaching "favorable dollar consequences in very large amounts to accepting as a working parameter unrealistic productivity assumptions."

To the extent that carriers' election says anything about productivity, it suggests that the difference between 4.7% and 5.3% can only provide an estimate of what LECs believe they could attain in a single tariff year. The one-year nature of the interim plan makes the difference between various productivity offsets much smaller. The multiple year effect of a specific productivity election is cumulative. Leaving the plan in place for only one year underestimates the long-term effect of electing a specific productivity offset option. Whether LECs can achieve such a high level of productivity over a longer term is another question entirely. Accordingly, the petitions demonstrate no basis for adopting a higher productivity factor.

2. Petitioners Present No Evidence Which Suggests that the Commission's Methodology Should In Fact Yield a Higher Productivity Factor

Each petitioner attempts to demonstrate that, having chosen to adopt an interim productivity factor using the Frentrup-Uretsky study without the 1984 data point, the Commission should have arrived at a higher productivity factor. However, no petitioner demonstrates why the Commission's chosen course of action should in fact lead to a higher productivity factor.

Ad Hoc claims the Commission erred because it improperly relied on updated information submitted by USTA to set the highest offset factor. Ad Hoc Petition at 2-3. AT&T suggests that the Commission should have relied on an AT&T analysis of earnings to set the minimum productivity factor. AT&T Petition at 3. MCI argues that the Commission should rely on Ad Hoc's, AT&T's, and MCI's evidence of higher productivity to set the minimum productivity factor higher.

Ad Hoc does not address the Commission's selection of a minimum X-factor, which served as the basis for determining the higher factors; in fact, Ad Hoc presents no evidence of LEC productivity. AT&T merely cites to its previous submissions, which were already considered and rejected by the Commission. MCI also presents no new evidence of LEC productivity; it also merely cites to evidence already considered and rejected by the Commission. There is nothing submitted here to reconsider.

Tellingly, MCI's petition is at war with its own filings in the price cap review proceeding. In an attempt to continually adjust the set of data on which the Commission relies to yield the highest possible productivity factor. MCI chastises the Commission for failing to determine a productivity factor based on data submitted by the CARE coalition, by Ad Hoc, by MCI, and by USTA regarding LEC performance since the adoption of price caps. MCI Petition at 4. Yet, during the Price Cap Review proceeding, MCI's own recommended methodology was to develop a productivity factor based solely on the short-term Frentrup/Uretsky study excluding the 1984 data point. See Price Cap Review Order, para. 135. (Lincoln criticizes MCI for not averaging short-term and long-term). This is in fact what the Commission did - it elected to rely on its own economists' study (the "Frentrup/Uretsky"study) of LEC productivity. Given this choice by the FCC, no petitioner demonstrates that the Frentrup/Uretsky study should yield a higher productivity factor.

In general, petitioners claims drastically overstate the extent to which their filings in the Price Cap Review proceeding actually added to the record on LEC productivity performance. None of the Petitioners actually examined LEC productivity. For example, AT&T presented evidence on LEC earnings. But earnings are a poor measure of productivity growth. As USTA has repeatedly pointed out, AT&T's suggestion that the Commission reach its decision by examining LEC earnings represents a thinly-veiled policy in favor of reintroducing rate-of-return regulation. MCI presented no new data on productivity, relying instead on its recommended removal of 1984 data from the Commission's own short-term study, and its recommendation to calculate productivity based only on that study. Ad Hoc supported TFP as the proper way to measure productivity growth, but provided no actual evidence of LEC productivity calculated by that method. In their petitions for reconsideration, petitioners present no new evidence, yet recommend that the Commission's analysis should in fact yield a higher interim productivity factor. The Commission should deny these petitions.

3. Petitioners' Arguments Based on Cost of Capital Are Internally Inconsistent and Do Not Reflect Actual Economic Evidence

AT&T contends that reconsideration is necessary because the Commission failed to properly account for a reduction in LECs' cost of capital, which had not been reflected in computing the LECs price caps nor in the one-time adjustment ordered by the Commission. AT&T Petition at 5; see Price Cap Review Order, para 236-256. MCI makes similar claims with respect to the effect of changes in the cost of capital on the Commission's decision not to recalibrate sharing bands. MCI Petition at 14. The Commission declined to either adjust LEC's PCI's or the sharing bands, for the same reason: it would be counterproductive to "correct" LEC earnings based on a comparison of those earnings to a rate-of-return measurement which served only as a "backstop," and which "blunts the incentives for greater productivity that price caps seeks to create." See Price Cap Review Order, paras. 187, 256.

Moreover, substantial evidence cited in the Price Cap Review Order demonstrates that there are in fact no changes to LECs' cost of capital which would have warranted adjustments had the Commission elected to rely on rate-of-return measurements to fulfill its statutory duties. For example, the Commission has retained 11.25% as the cost of capital for cable companies. Report and Order and Further Notice of Proposed Rulemaking, Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, 9 FCC Rcd 4527 at ¶ 207 (1994). Contrary to AT&T's claims, changes in interest rates are already reflected in the GNP-PI component of the price cap adjustment formula. AT&T Petition at 5; see Price Cap Review Order, para. 182.

MCI's Petition makes several unusual claims on this issue. For example, MCI argues that the Commission erred by considering only the cost of debt. MCI Petition at 15. But the Commission has noted on prior occasions that the cost of debt and cost of equity generally move in the same direction. Accordingly there was no error in considering only the cost of debt to make a threshold determination that there were no significant changes in the cost of capital figure which might then require further examination. Indeed, MCI's Petition suggests that the Commission erred in failing to demonstrate that there is not a "sustained downward trend" in the cost of debt. MCI Petition at 15. Of course, MCI did not, nor could it prove its necessary premise: that such a downward trend is in fact demonstrable. To grant reconsideration based on MCI's objection, the Commission must find that MCI, alone among all market observers, can predict where interest rates are headed. In contrast, the Commission reasonably determined that any changes in the cost of capital were not so significant as to require adjustments to the rate-of-return measurement. Price Cap Review Order at para. 255.

For its part, Ad Hoc makes a similarly misplaced attempt to demonstrate a basis for reconsideration. Ad Hoc claims that the Commission may not "sever the link between carriers' rates and the carriers' cost of service, including the cost of capital." Ad Hoc Petition at 9. Neither the Commission's interim plan, nor its proposal to eliminate sharing obligations wherever possible, sever this link. For example, the Commission's proposed adoption of a rolling average-based X-factor, as well as any necessary exogenous changes, would account for any important changes in LEC costs. Moreover, Ad Hoc seems to claim that the Commission failed to ensure that LEC earnings, as opposed to rates, remained just and reasonable. As far back as 1988, the Commission noted that the fundamental purpose of price caps was to in fact sever the link whereby rates were regulated by measuring earnings, and thus create incentives for carriers to increase efficiency and innovation. See Further Notice of Proposed Rulemaking, CC Docket 87-313, 3 FCC Rcd 3195, 3262 (paras. 124-126)("Docket 87-313 Further Notice"). In asking what are the limits on carriers' earnings under the Communications Act, Ad Hoc asks the wrong question. The Act requires rates (and terms of service) to be just and reasonable - it says nothing about earnings. See 47 U.S.C. § 201(b)("All charges, practices, classifications, and regulations . . . shall be just and reasonable).

4. LEC Performance Need Not Be Measured on An Interstate-Only Basis

Ad Hoc asks the Commission to again consider its argument that TFP-derived offset factors for interstate services must be based on examination of interstate productivity, for the implicit reason that such a methodology would yield a higher productivity factor. Ad Hoc's explicit reasons are two: 1) because of higher demand growth, productivity for interstate services is higher, and 2) the Commission is legally obligated to calculate interstate rates based on jurisdictionally separated factors. See Ad Hoc Petition at 12-13. Both of these arguments have been presented before and neither warrants reconsideration.

As a threshold matter, Ad Hoc asks the Commission to reconsider a tentative conclusion, which the Commission states will be subject to revision if parties can establish a downward bias created by inclusion of intrastate performance data. Price Cap Review Order at para. 159. Accordingly, no reconsideration is warranted at this time. Moreover, Ad Hoc's argument fails to demonstrate why the Commission's rationale is flawed. As Ad Hoc notes, the Commission's rationale for utilizing total company productivity is that no party demonstrated that LEC inputs and outputs significantly differ for intrastate and interstate services in a way that can be readily measured. Ad Hoc Petition at 11, citing Price Cap Review Order at para. 159.

As the Commission noted, the fact that intrastate and interstate services share common facilities (and thus common inputs) demonstrates that any difference in outputs does not demonstrate two meaningfully different measures of productivity. Price Cap Review Order, para. 159, n. 309. Ad Hoc argues that meaningful differences in productivity exist, even if inputs are similar, because outputs do in fact differ. Ad Hoc misstates the argument made by the Commission. The Commission noted that interstate and intrastate services have common inputs, not similar inputs. Thus, separation of these inputs, using existing accounting rules, may not fully reflect economic costs. This is not the same argument raised by Ad Hoc, which attempts to argue that differences in outputs, relative to identical inputs, yield meaningful differences in productivity. This reasoning is flawed. The Commission correctly decided to calculate productivity on a total company basis.

Ad Hoc's citation to Smith v. Illinois Bell Telephone Co., 282 U.S. 133 (1930) is inapposite. Under Smith, "[t]he proper regulation of rates can be had only by maintaining the limits of state and federal jurisdiction, and this cannot be accomplished unless there are findings of fact underlying the conclusions reached with respect to the exercise of each authority." Id., 282 U.S. at 149. Nowhere in Smith does the court suggest that such findings of fact must result from direct examination; rather, it has long been understood that the Commission may utilize economic tools, such as proxies, developed by whatever means, to develop the findings which support regulation of interstate rates. For example, Ad Hoc notes that interstate rates should be calculated using the economy-wide measure of inflation. Nowhere does Ad Hoc suggest that the Commission must calculate the rate of output growth in interstate telecommunications services alone, in order to remain consistent with Smith. See Ad Hoc Petition at 13. Clearly, the Commission can properly calculate LEC productivity on the basis of total company performance.

Lastly, MCI argues that the Commission failed to adequately justify its decision to adopt three different productivity factors. MCI Petition at 5. MCI claims that, because LECs have all increased their productivity (and consequently, earnings), their performance is not heterogeneous. But the fact that LEC productivity is trending the same way does not demonstrate that LECs' productivity growths are identical.

MCI also claims that the fact that no price cap tariff entity selected the "middle" option supports elimination of a three-tiered productivity offset plan. MCI Petition at 5-8. The fact that no tariff entity selected the "middle" option may indicate that this specific version of a three-tiered plan may not have been properly aligned, but it does not indict the policy in favor of creating options for carriers. Moreover, this fact demonstrates that the "complexity," about which MCI (and Commissioner Ness) were concerned, MCI Petition at 7, quoting Dissenting Statement of Commissioner Susan Ness at 2, has not materialized.[3]

More importantly, MCI is essentially asking the Commission to reconsider the policy decisions which underlie its price cap system of regulation. MCI claims that the availability of three productivity factors will give LECs "greater scope to game the system, tailoring their productivity choice in a way that maximizes their return, rather than rate decreases to ratepayers." As the Commission explained long ago, "reducing a carrier's potential reward for efficiency and innovation diminishes its incentive to undertake the effort necessary for such activity in the first place." Docket 87-313 Further Notice, 3 FCC Rcd at 3262. The productivity factor must permit ratepayers to share in the benefits of greater efficiencies, without creating a "zero-sum game" by eliminating the incentives for the LECs to create those greater efficiencies. Id. Accordingly, the Price Cap Review Order determined that the

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[3] While MCI and Commissioner Ness apparently believe that three factors will engender further uncertainty, Commissioner Barrett noted that permitting LECs to choose from three factors may actually mitigate the uncertainty resulting from adoption of an interim plan. Separate Statement of Commissioner Barrett at 2.

selection of three X-factor options would achieve a "better balance of ratepayer and shareholder interests for each LEC and its customers. Price Cap Review Order, para. 213.

The exploration of options for LECs can and should be a major focus in the Further Notice in this proceeding which will shape an enduring LEC price cap framework. That framework must adapt and increasingly rely on market forces rather than explicit regulatory constraints as competition in telecommunications markets further increases. The record on price cap options will develop further. USTA supports the Commission's decisions to provide options for LECs, and MCI's request to eliminate options should be denied.

II. Petitioners' Arguments Concerning the Sharing and Low-End Adjustments are in Conflict With the Fundamental Price Cap Policy Established by the Commission.

A. Petitioners Demonstrate No Error in the Commission's Decision to Eliminate Sharing When LECs Select the 5.3% X-Factor

The Commission properly concluded that the sharing mechanism deprives LECs and their customers of the full benefits of lower prices and improved efficiency that a pure price cap scheme can offer. Price Cap Review Order, para. 191 (emphasis added). Yet, Ad Hoc and MCI argue that the Commission failed to explain its decision to remove sharing under the interim price cap plan. Ad Hoc petition at 5; MCI Petition at 10. Moreover, MCI argues that removing sharing is inconsistent with the finding that LECs are dominant carriers, and with Section 201 of the Communications Act, 47 U.S.C. § 201. MCI Petition at 11-13.

MCI claims the Commission's explanation for this action is "virtually nonexistent." The Commission's explanation is found in large part in the statement above, evidencing a policy to eliminate sharing obligations wherever possible. See also Price Cap Review Order, para. 197("we tentatively conclude that the existing backstop mechanisms should eventually be eliminated.") Accordingly, having selected 5.3% as the highest productivity offset, the Commission retained sharing for lower factors in order to provide incentives for carriers to select the highest practicable X-factor. See, e.g., Price Cap Review Order, para. 200. This justifies the elimination of sharing for LECs who select the 5.3% productivity factor.[4]

MCI also claims that, because LECs retain market power LECs will substantially outperforms the 5.3% productivity goal, and their rates will rise to unreasonable levels. This, of course, presumes that LECs will in fact outperform the 5.3% offset; essentially MCI is again asking for reconsideration of the Commission's selection of an interim productivity factor without presenting any new facts or argument. Moreover, MCI's argument is fundamentally flawed. MCI claims that to prevent LECs from raising rates to unreasonable levels, the Commission must continue to restrain LECs' earnings. MCI Petition at 13. This is an argument for a return to mandatory rate-of-return regulation. Under price caps, LECs are unable to raise rates over the price cap, even where they retain market power, without extraordinary cost showings. For LEC rate changes within the banding constraints the Commission has declared them to be prima facia reasonable. In any event, a LEC cannot increase productivity by raising rates (even so, such a strategy would not likely meet with much success in an increasingly competitive market.) In order to substantially outperform the

[4]As discussed above, the fact that some LECs selected the 5.3% X-factor in their 1995 annual access tariff filings provides no logical basis for the conclusion that achieving that productivity level is a "cakewalk." See MCI Petition at 11.

productivity offset, the LEC must do so by reducing the cost of inputs, or by increasing its internal efficiency.

The Commission has already rejected allegations that Section 201 of the Communications Act, 47 U.S.C. § 201, requires sharing. In fact, the Commission rejected any argument that Section 201 was triggered by its review of the record. Price Cap Review Order, para. 254 ("we emphasize that we have not found that LEC rates . . . were unreasonably high.").

Section 201 requires the Commission to ensure that rates are just and reasonable, but it does not obligate the Commission to do so by regulating earnings. See also Ad Hoc Petition at 8 ("the Commission surely has flexibility in selecting the methods it will use to assure that carriers' rates are just and reasonable"). Neither AT&T, nor cable television companies, nor LECs under 50,000 lines (all of whom the FCC concluded have market power), are subject to sharing mechanisms in conjunction with their incentive regulation plans. See Price Cap Review Order, para. 225. Ad Hoc only repeats old arguments regarding Section 201 that have already been considered and rejected.

B. AT&T Is Incorrect To Suggest That Carriers Who Elect the 5.3% Productivity Factor Are Nonetheless Subject to a Sharing Obligation For the Last Seven Months of the Current Access Tariff Year

AT&T argues that the Price Cap Review Order should be clarified to indicate that carriers who elect a 5.3% productivity factor will nonetheless be subject to an ongoing sharing obligation with respect to the last seven months of the current access tariff year - January 1 through July 31, 1995. AT&T argues that sharing is required to compensate for inadequate productivity adjustments, and that the Commission has found that the price caps for this period were calculated utilizing inadequate productivity adjustments. AT&T Petition at 7.

AT&T is incorrect to suggest that the sharing obligation should be based on the seven calendar months in 1995 prior to the August 1 effective date of the LECs annual access tariffs. The Commission has already adjusted to account for the one month delay in the effective date.[5] The Commission's adjustment dictates that LEC annual access tariffs will have the same financial result as if they had been made effective on July 1, 1995. Therefore, the sharing obligation is only required for the first half of the calendar year 1995.

AT&T raises several other issues which also require clarification. If AT&T believes that sharing must continue due to "inadequate productivity adjustments," then AT&T should also agree that where a LEC elects to apply the highest productivity adjustment (5.3%) retroactively to January 1, no sharing obligation for that period should pertain. No party has demonstrated that the 5.3% productivity factor constitutes an "inadequate productivity adjustment." Absent an inadequate productivity adjustment, there is no basis to apply the backstop mechanism of sharing.

By misrepresenting Ameritech's petition addressing this issue, AT&T claims that a

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[5] See Cost Support Material to be Filed with 1995 Annual Access Tariffs, Revisions to Tariff Review Plan for Price Cap Companies and Order, DA 95-823, paras. 19-21 (rel. April 14, 1995).

waiver is required to effectuate this result. AT&T Petition at 8. In a footnote, however, AT&T notes that Ameritech's petition is in fact captioned "Petition for Clarification or Waiver." Id., n.10; see "Petition for Clarification or Waiver, Annual 1995 Access Tariff Filings (May 9, 1995). Ameritech is correct to presume that the Commission can alternatively permit a carrier to continue the existing price cap structure (with sharing), or allow it to retroactively adopt the 5.3% X-factor.

LECs may calculate sharing for this period utilizing the "blending" process from the Commission's existing precedent for how such calculations should be made when two different productivity factors (with two different associated sharing obligations) are applied to a particular calendar year. For example, BellSouth performed the calculation of sharing by blending the two earning caps (12.25% and 13.25%) associated with the 3.3% and 4.3% productivity factors and used an achieved rate of 12.75% to calculate its sharing obligation for the calendar year this occurred.[6] Thus, where a LEC elected the 5.3% productivity factor, but had a 3.3% factor applicable for the first half of 1995, the LEC would calculate its sharing obligation by assuming a 12.25% return for the entire year, apply that return to the total on its annual Form 492A, and then take half that amount for the sharing obligation (since sharing was required for half the year). Applying the Commission's existing methodology does not understate the sharing obligation. The blended amount combines the sharing threshold of the

[6] See, e.g. In the Matter of Cost Support Material to be Filed with 1995 Annual Access Tariffs, Tariff Review Plans, DA 95-264 (released February 17, 1995), para. 21 ("1995 Access Tariff Order"); In the Matter of Cost Support Material to be Filed with 1994 Annual Access Tariffs, Order, DA 94-165 (released February 18, 1994), para. 23 ("1994 Access Tariff Order").

old price cap plan (12.25%, or 13.25% where companies elected the 4.3% factor) and the sharing threshold of the new plan (no upper limit).

C. AT&T and MCI Demonstrate No Basis to Remove the Low-End Adjustment Factor Mechanism For LECs Electing the Lower Productivity Factors

AT&T claims that the LFAM is unnecessary because the previous 3.3% and 4.3% productivity factors have been found to be understated. AT&T Petition at 9. MCI claims that retaining the low-end factor adjustment mechanism (LFAM) for carriers who elect either the 4.0 or 4.7 interim productivity factor is redundant and contrary to the public interest. MCI Petition at 16. None of these arguments shows that the Commission erred in retaining the LFAM mechanism to protect LECs from confiscatory rates when they select either of the lower interim productivity factors.

AT&T's claim that the earlier productivity factors were understated has no bearing on whether LECs who select, e.g. a 4.0% interim productivity factor, will earn below 10.25% in the interim period. MCI's claim that the LFAM is redundant was considered and rejected by the Commission in the Price Cap Review Order. The Commission clearly indicated that mechanisms such waivers were burdensome to the Commission, the LEC and the customer. (For example, any above-cap tariff filing would be suspended for the full five-month statutory period. See Price Cap Review Order, para. 223.) The ability to file above-cap rate increases or seek waivers does not make LFAM redundant.

MCI also claims that the LFAM creates incentives which are not in the public interest.

But LECs may in fact be responding fully to the incentives to greater productivity, yet not achieve earnings above the 10.25% level. As Commissioner Ness explains, there are a variety of reasons why LECs may not achieve certain productivity levels, not all of which are within the LEC's control. Separate Statement of Commissioner Susan Ness, at 4. Moreover, so long as LECs face disincentives to higher productivity through the retention of sharing obligations, they should not be penalized through confiscatory rates if LEC productivity falls short of the Commission's estimated levels. See Price Cap Review Order, para. 223, citing AT&T v. FCC, 836 F.2d 1836 (D.C. Cir. 1988).

III. Petitioners Have Not Demonstrated that the Commission's Treatment of the Common-Line Basket was Erroneous.

Both AT&T and MCI resurrect their arguments that the Commission must adopt a "per-line" price cap index for the common line basket. AT&T claims that adoption of the per-line formula is justified because, although utilization of a total factor productivity (TFP) mechanism would account for common line productivity and not require a common line cap adjustment for demand growth, there is no assurance that the Commission will ultimately adopt a TFP-based price cap formula. AT&T Petition at 11. Neither petitioner demonstrates that adoption of the per-line formula for the interim plan is warranted.

AT&T's argument proves too much: if the decision whether to adopt a TFP method has not yet been made, then there is no basis to adopt a per-line method which may be unnecessary. The Commission was correct to note that selection of an appropriate price cap indices (PCI) is fundamentally linked to the selection of productivity offset levels and methods.

Price Cap Review Order, para. 271. Moreover, adopting a per-line method for the interim period only would, as the Commission noted, create excessive rate churn and confusion, which would outweigh any benefits created by adopting the per-line mechanism. Price Cap Review Order, para. 272.

MCI claims that no churn or confusion would result because the per-line formula is no less complex than the balanced 50/50 formula, and because LECs would not have to recompute their PCI if they switched to the per-line formula. MCI's claim, however, rests on the assumption that LECs would instead be subject to a recalculated productivity factor. MCI Petition at 20; see also Price Cap Review Order para. 269, n. 504 (suggesting indirect changes in the carrier common line rate derived from recalculation of the overall X-factor to include the growth in minutes per line in the X-factor itself). MCI must acknowledge the inexorable link between the selection of productivity offset levels and methods, and development of appropriate PCI's. There is simply no way for the Commission to adopt the per-line methodology for the interim plan, consistent with its decision to examine whether to adopt a TFP-based method of calculating the productivity offset.

Moreover, the merits of the per-line formula are not so clearly resolved as AT&T and MCI suggest. As MCI notes, PCI's in the past were set using the 50/50 formula - which assumes that CCL revenue is approximately 50% of total Common Line revenue. See MCI Petition at 20, Price Cap Review Order, para. 258. Because the current formula is totally insensitive to shifts over time in revenue shares, and because revenue shares have in fact shifted, adjustments to the Common Line PCI formula should also reflect those shifts. These shifts may better be reflected through a TFP-based offset than by use of the per-line formula.

Additionally, the present common line formula, see 47 C.F.R. 61.45(c), which contains an element "g" measuring growth in minutes of use per access line, already overstates the total benefit of common line minute growth received by most LECs, and thus already produces effects closer to that which would be produced by a per-line formula. This is because the majority of common line revenues are in fact recovered on a per line rather than per minute basis.[7] Revenues recovered on a per line basis do not receive any benefit of minute growth, thereby obviating the need for any "g" element adjustment for these revenues. Accordingly, a per line "g" adjustment (to change "g/2" in the formula to simply "g") would be inappropriate given the small level of revenues recovered on a per-minute basis.

Finally, the fundamental premise on which MCI and AT&T must rely to find that the Commission erred -- that LECs do not influence demand -- is far from self-evident. In the Price Cap Review Order, the Commission said that "it appears that an individual LEC has little ability to increase its traffic per common line by reducing its individual CCL rates." Price Cap Review Order, para. 268. This carefully-restricted statement is not broad enough to serve as the basis for adopting a per-line formula because it applies only to a single LEC and its individual rates.

[7] On average, 68% of common line revenues are recovered on a per line rather than a per minute basis (total industry end user common line revenue divided by total industry common line revenue). For some companies, this ratio is much greater, i.e. Lincoln Tel.Co.'s is 93%.

Viewing the very same issue from a broader perspective, the Commission's reasoning leads to the conclusion that LEC access reductions have had significant effects on LEC access demand. The Review Order states that "since 1984, decreases in the prices for interstate toll services caused by Federal Communications Commission reforms in the pricing of interstate access services and competition among long distance companies helped stimulate a 100 percent increase in interstate long distance calling." Price Cap Review Order, para. 2. Using the Commission's own logic, LEC access charge reductions stimulate long distance calling, which results in increased access usage. (If IXCs pass through 100% of access charge reductions, then the effect of LEC access reductions on interstate calling would be at its maximum.)

There is little risk that LEC's common line rates will be overstated as a result of retaining the balanced 50/50 methodology until the adoption of a long-term price cap plan. The end result is that the best resolution of the common line question is to retain the present 50/50 plan for the interim period, and adopt for the long-term a TFP-based methodology which incorporates the effects of LEC output growth and eliminate the need for a common line adjustment formula. Price Cap Review Order, para. 260; see Comments of USTA, LEC Price Cap Review, CC Docket 94-1 (May 9, 1994), at 84.

IV. Petitioners Suggestions With Respect to Certain Exogenous Cost Adjustments Should Not be Adopted.

Both AT&T and MCI suggest that the Commission must reconsider certain decisions with respect to treatment of exogenous costs. AT&T claims that the Commission erred in failing to require exogenous treatment of fully amortized LEC equal access and network reconfiguration costs (EANR). AT&T Petition at 13. MCI again raises its arguments about the scope of exogenous cost changes, and requests reconsideration of the Commission's decision on exogenous treatment of the sales and swaps of exchanges. MCI Petition at 22. Neither petitioner presents arguments of merit.

A. The Commission Should Again Reject MCI's Proposal to Limit Exogenous Treatment to Cost Changes Affecting the Interstate Jurisdiction.

MCI's proposal to limit exogenous treatment to changes which shift money in or out of the interstate jurisdiction is unsupported by any new arguments. Moreover, MCI demonstrates no new arguments why the Commission erred in deferring consideration of this proposal to the further notice. No reconsideration is necessary at this time as this subject will be revisited in the FNPRM. See Price Cap Review Order, para. 303.

B. The Commission Should Also Reject AT&T's Proposal To Require Exogenous Treatment of EANR

AT&T states the Commission "failed without justification to require exogenous treatment of equal access and network reconfiguration (EANR) costs that have been fully amortized." AT&T also states that the Price Cap Review Order ignored AT&T's showing because the Common Carrier Bureau had denied exogenous treatment in the 1994 Annual Access tariff filings. AT&T Petition at 16. The Commission has already denied AT&T's request for exogenous treatment of EANR in a number of proceedings, and it should do so again here.

For example, the LEC Price Cap Order released October 4, 1990, in CC Docket No. 87-